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US SOUTHCOM FOR POLAD

E.O. 12958: N/A
TAGS: AR ECON EINV ETRD EFIN ENRG PGOV
SUBJECT: Argentina: Economic Challenges Facing the Incoming Government

Refs:
(A) Buenos Aires 2021
(B) Buenos Aires 1995 and prior

Summary and Introduction

¶1. (SBU) The inauguration of a new Argentine president in December 2007 will coincide with the conclusion of the Argentine economy's fifth (2003-2007) consecutive year of 8-9% real growth, and record levels of exports, foreign reserves, and formal employment. Argentina also enjoys solid, if declining, budget and current account surpluses. However, the new administration will face many economic challenges: Argentina's good times have been accompanied by a mounting pressure cooker of distortions and government interventions, including inflation, price controls, alleged economic data manipulation, growing subsidies, low investment levels, energy shortages, stubbornly-high poverty levels and corruption. All of these require near term attention if Argentina is to continue its remarkable recovery from the 2001 crisis and achieve sustainable growth levels. Delaying reforms will make their resolution more politically and economically painful. Taking prompt corrective measures and beginning a process of change offers an incoming administration an opportunity to demonstrate to its citizens and to the international community that it will take responsible action, and that Argentina does not have to be condemned to boom-and-bust economic cycles. End Summary and Introduction.

Inflation: Old Ghost Stalks Again

¶2. (SBU) According to domestic polls, inflation is the number one economic problem facing Argentina, one that undermines public trust in government and disproportionately affects the poor. Inflation spooks the Argentine public and potential investors, given the country's painful history of hyperinflation. As reported Ref A, true inflation is currently running at about 15%-20% -- roughly double the official rate -- and accelerating.

¶3. (SBU) Inflation is the most visible symptom of a broader problem, an overheating economy, the consequence of the GoA's expansionary fiscal, monetary, incomes and exchange rate policies to push domestic demand-driven growth. Since 2005, the GoA has used microeconomic methods -- price controls, export restraints, and public service subsidies -- in a failed attempt to control inflation without slowing economic output. The big test for the next administration will be whether it has both the political will to use more orthodox policies and/or tools to slow growth to sustainable levels, reduce inflationary pressures, and unravel the web of distortionary microeconomic policies. These policies are now linked to the point where an attempt to change one inevitably requires changes to others.

Price Controls

¶4. (SBU) Beginning in late 2005, in response to signs of increasing inflation, the GOA ratcheted up pressure on businesses and instituted "voluntary" price accords for primary consumption items with retailers and supermarkets. Two years later these efforts have largely failed to reduce inflation, and have further undermined public and investor confidence. As widely predicted, the results have been shortages, black markets, distortions and limited new investment in affected sectors. Even the few private sector economists who expressed qualified support for price controls always underlined their strictly short-term nature. The longer price controls persist, the more difficult and costly it will be for the economy to extricate itself later. The GOA needs to find a graceful exit or process soon.

INDEC: Alleged Statistical Manipulation

¶5. (SBU) Facing the failure of its dirigiste efforts to control inflation, the GoA took a bolder step: direct manipulation of official statistics. Beginning in January 2007, the highly regarded GOA statistics agency, INDEC, began reporting monthly inflation numbers significantly below market estimates. GoA officials allegedly intimidated INDEC employees and forced those that refused to alter the numbers to resign, replacing them with Kirchner government stalwarts. The manipulation has apparently worsened as the October 28 elections have approached, and the official estimate of 8-9% inflation for 2007 is roughly half of private estimates of 15-20% (Ref A and Buenos Aires 1545).

¶6. (SBU) Questions are now being raised about the veracity of other INDEC-provided data, such as GDP growth, poverty, indigence levels, incomes, and unemployment. The GOA's actions have not only degraded INDEC's prestige and credibility, but also further eroded Argentina's institutional and investment climate. Some foreign creditors even consider the GoA intervention as a "credit event," or equivalent of a default, spurring them to sell GoA bonds. Several parallel inflation indices have emerged, by economists, think tanks and politicians, all adding to worsening public trust of the GOA. One consequence has been reduced GoA influence over union wage pressures and inflationary expectations: unions no longer believe or accept official inflation figures, and many have laid down markers that they will demand 2008 wage increases greater (up to 30%) than even private inflation estimates.

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Public Utilities: Frozen Tariffs and Subsidies
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¶7. (SBU) Since 2002, transport fares and energy tariffs, particularly for the residential sector, have remained largely frozen, while international prices for gas and oil - and salaries for these sectors' workers - have soared. A ride on the Buenos Aires subway, for example, is just 22 cents, the same as in 2002. To maintain these low prices, the GOA has accelerated subsidy payments to energy, bus, rail, and air transport service providers, often utilizing non-transparent transfer mechanisms (Ref B) that have led to many allegations of corruption. As a consequence, energy-related 2007 public transfers will increase to an estimated

1.5% of GDP (vs. 0.7% in 2006), a more than 100% increase over 2006 levels which, in turn, were more than 80% higher than 2005 levels.

¶8. (SBU) For the GOA, the calculus is simple: either continue subsidies to maintain these everyday prices for large and important urban voting constituencies, or ease subsidies, bringing increased transport and energy fares - and voter wrath. The GoA will eventually have to cut subsidies and increase these tariffs, which could tamp soaring demand, ameliorate shortages, and create incentives for needed investments.

Distortionary Export Tariffs, Export Bans

¶9. (SBU) Since 2002, the GOA has imposed high and distortionary export tariffs on almost all tradable (largely agricultural) products, allowing the GOA to insulate domestic prices from international prices of Argentine exportable goods, partly alleviating inflation and poverty. Export taxes have also allowed the GOA to capture increased economic rents resulting from the devaluation of the peso and high international commodity prices. In 2006, the GOA also resorted to a six-month beef export ban in an attempt to moderate surging domestic prices for this product, and still maintains beef export volume limits.

¶10. (SBU) Export tariffs, particularly those on primary commodity exports, have contributed a growing share of tax collections, and is
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now the GoA's third most important source of revenues (after VAT and income taxes) and a key contributor to the primary fiscal surplus (the surplus excluding debt interest payments) in recent years. Export tariffs totaled 9.3% of total tax revenues in the first half of 2007, and represented 64% of the GOA's primary fiscal surplus in ¶2006. The GoA has also made clear that export tariffs are its mechanism of choice (under its comprehensive industrial promotion/protection policy) to transfer wealth from the nation's relatively well off agricultural sector to the less competitive industrial sector (Ref E). These distortionary taxes discourage investment and weaken competitiveness in a sector in which Argentina enjoys comparative advantage.

Public Spending Binge, Fiscal Implications

¶11. (SBU) As reported Ref B, GOA spending through July 2007 has increased almost 50% from 2006, mainly due to increased pension, subsidy, wage and public infrastructure capital expenditures, all with the apparent goal of buying votes for the October elections. One of the most important accomplishments of the Kirchner administration, a healthy primary fiscal surplus, is diminishing, and the national consolidated balance (including provincial finances and interest payments on debt) is now nearing zero.

Energy Shortages

¶12. (SBU) As a result of low tariffs, resulting high demand, and insufficient investments, energy shortages have emerged, particularly for natural gas and diesel (Buenos Aires 1496). Further, private electricity sector players here (including U.S. companies) say that the GoA's freezing of energy prices and manipulation of the methodology used to set market prices have unilaterally abrogated contracts, effectively confiscating funds owed to them. The consequence has been a raft of international ICSID arbitration claims filed against the GoA that total in the billions of dollars.

¶13. (SBU) Public anger at energy disruptions during the recent (austral) winter have certainly exacted a political cost, but the GoA's stop-gap measures to import more electricity from Brazil and to subsidize diesel fuel for Argentine thermal plants will likely see the GoA through to the next (austral) summer peak demand season. The Kirchner administration clearly believes that cheap energy that helps expand consumer purchasing power is its best pre-election

strategy, and it has been willing to pay dearly to import peak demand electricity from Brazil and to subsidize diesel supplies for domestic generators. Argentina is in dire need of a wholesale energy policy overhaul that includes not only a liberalization of energy prices but the design and application of a clear pro-investment energy regulatory framework. Otherwise, its strong recovery could be in jeopardy.

Undervalued Peso Fuels Inflation

¶14. (SBU) Although nominally independent, in practice the Central Bank has followed the direction of the executive. The apparent policy goals behind the GOA's artificially low, "competitive" peso are import substitution, industrialization, full employment, and boosting exports and tourism. Also crucial for the GOA, an undervalued peso sustains the GOA's export tariff revenues (see para 10). However, the downsides are higher inflation and the Central Bank's loss of ability to maintain price stability. The GOA cannot defy the principles of economics to have it both ways - maintain a "competitive" exchange rate and use monetary policy to moderate inflation.

Paris Club, Holdouts, ICSID

¶15. (SBU) The GOA faces significant debt arrears and contingent liabilities that could add substantially to government debt in the coming years (Ref B). These cases require resolution. The GOA owes about $6.5 billion in Paris Club debt, including about $400 million to the U.S. Government. It owes about $25 billion to "holdouts," bondholders that did not participate in the 2005 debt exchange. Foreign multinationals, including many U.S. energy players, have roughly $13 billion in outstanding claims against Argentina before the World Bank's International Center for the Settlement of Investment Disputes (ICSID), the bulk of which date from the 2001-2002 economic crisis. Roughly 19% of total ICSID claims are held by U.S.-based firms. A number of cases have been decided by ICSID tribunals against Argentina. Should the GoA refuse to pay out ISCID rewards, the risk premium foreign investors demand to commit new capital to Argentine ventures would increase, worsening Argentina's already difficult investment climate.

Poverty, Indigence and Income Gaps

¶16. (SBU) Although Argentina has made remarkable progress in alleviating poverty and improving income distribution since the 2001/2002 economic crisis, it still faces sobering challenges. Overall poverty stands at about 30 percent. Almost 49% of all citizens under 14 fall under Argentina's poverty line; 20% of this same group are considered indigent. 41% of the labor force remains informal. Income inequality is beginning to grow again as the (effectively) regressive tax of inflation disproportionately impacts the poor. Embassy contacts and private economists note that these challenges could be socio-economic time bombs and require urgent GOA attention.

Under-Investment and Investment Climate

¶17. (SBU) For Argentina to continue its recovery, even at more sustainable growth rates of 5-6%, investment must increase above the current levels of 22%-23% of GDP. Argentina also needs higher quality investment; currently a substantial share of investment is concentrated in areas such as construction that do not add significantly to the nation's productive capacity. A recent UNCTAD report on global foreign direct investment highlighted Argentina's low and declining share of global FDI.

¶18. (SBU) Quality investment begins with a good investment climate. According to most private sector analysts, to attract higher levels and quality of investment, Argentina needs to address institutional

weakness, corruption, the over-concentration of power in, and the tendency to impose abrupt regulatory changes by, the executive branch, and perceptions of weak contractual sanctity. (Buenos Aires 1947 elaborated upon recent poor GOA marks in the areas of corruption and ease of doing business.) The challenge is for the GOA to address the more intractable problems of legal uncertainty, institutional weakness, and inconsistent application of the rule of law.

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Comment: A Reform Agenda for the New Government
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¶19. (SBU) Although analysts differ in their perceptions of how and in what sequence the new government should address these often linked and overlapping challenges, there is broad agreement on the basics:
-- First and foremost, sustaining a strong primary fiscal surplus is fundamental, as it has a moderating effect on inflation and country risk premiums and allows the GoA flexibility in managing its still substantial debt overhang. This will in all likelihood require an incoming administration to sharpen its budget pencil and cut billions in recently announced public infrastructure investment spending.
-- Second, easing distortionary price controls and linked subsidies could encourage new investment in affected sectors, though most agree that any abrupt removal of existing controls would result in an inflationary spike that would color Argentine consumers' expectations.
-- Third, INDEC's institutional independence needs to be restored. (As per ref A, the GoA is already taking steps to introduce a "new" USG-based inflation calculation methodology that could allow the GoA to step back gracefully from alleged manipulation.)
-- Fourth, public utility energy and transport tariffs should be allowed to transition upwards to regional market levels, a step that would provide incentives for badly needed infrastructure investment.

-- And fifth, the GOA must begin to address its unresolved Paris Club, holdout, and ICSID-related obligations, which in turn could improve Argentina's access to global capital markets and improve the nation's investment climate.

¶20. (SBU) Given Argentina's volatile economic history, citizens and markets will be especially sensitive to the actions the GOA takes -- or fails to take. There is a general consensus that the longer the incoming GoA administration waits to take these corrective actions, the more painful -- both economically and politically -- these corrections will be. The Argentine economy is still enjoying a tail wind of buoyant domestic and regional growth, continued high global commodity prices for key Argentine exports, positive (albeit declining) fiscal and current account balances, and manageable financing costs. By initiating policy changes in the initial period of the new Presidency, the incoming administration can reassure its citizens, the markets and the international community that repeated booms and busts do not have to be Argentina's eternal fate, and moderate growth and stability is achievable.

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